

Message Text

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ACTION ARA-20

INFO OCT-01 ISO-00 SP-03 AID-20 EB-11 NSC-07 RSC-01

CIEP-03 TRSE-00 SS-20 STR-08 OMB-01 CEA-02 CIAE-00

COME-00 FRB-03 INR-11 NSAE-00 XMB-07 OPIC-12 LAB-06

SIL-01 DODE-00 PA-04 USIA-15 PRS-01 ABF-01 FS-01

DRC-01 /160 W

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P R 032119Z SEP 74

FM AMEMBASSY MONTEVIDEO

TO SECSTATE WASHDC PRIORITY 7226

INFO AMEMBASSY BUENOS AIRES

AMCONGEN RIO DE JANEIRO

AMCONGEN SAO PAULO

C O N F I D E N T I A L MONTEVIDEO 2488

E.O. 11652: GDS

TAGS: ECON, EFIN, UY

SUBJECT: FINANCIAL RATE LIBERALIZATION

REF: MONTEVIDEO 2259

1. SUMMARY: BY A PRESIDENTIAL ORDER SIGNED BY MINISTER OF ECONOMY VEGH VILLEGAS TO THE PRESIDENT OF THE CENTRAL BANK, THE FINANCIAL FX RATE IS TO BE COMPLETELY FREED OF EXCHANGE CONTROL AND PERMITTED TO FLOAT. CONSEQUENTLY, THIS RATE WILL BE DETERMINED BY FREE MARKET FORCES AND WITH NO LIMITATION ON ACCESS TO THE MARKET. THE COMMERCIAL RATE GOVERNING FOREIGN TRADE WAS NOT AFFECTED BY TODAY'S ANNOUNCEMENT. THE NEW SYSTEM WILL GO INTO EFFECT AS SOON AS REGULATIONS ARE PREPARED--EXPECTED IN A FEW DAYS. IN THE MEANTIME, FINANCIAL FX TRANSACTIONS ARE PRACTICALLY PARALYZED AS PUBLIC AWAITS IMPLEMENTATION OF THE NEW RULES. END SUMMARY.

2. IN A SIGNIFICANT STEP TOWARD THE ECONOMIC LIBERALIZATION
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GOALS PROCLAIMED BY THE GOU AT SAN MIGUEL AND PARTICULARLY

MINISTER VEGH VILLEGAS (SEE REFTTEL), IT WAS ANNOUNCED ON SEPT. 2 THAT THE GOU WOULD ALLOW FREE CONVERSION OF FX AT A FLOATING RATE FOR ALL NON-TRADE PURPOSES. CENTRAL BANK IS DIRECTED TO INTERVENE IN THE MARKET ONLY AS REQUIRED TO MODERATE SPECULATIVE SWINGS, BUT IS NOT TO ACT AGAINST ANY FUNDAMENTAL TENDENCIES OF THE MARKET. UNTIL NOW FINANCIAL RATE WAS LIMITED TO APPROVED TRANSACTIONS, AND, WHILE THEORETICALLY FLOATING, HAD IN FACT BEEN CONTROLLED BY CB. THE OFFICIAL COMMUNIQUE REPEATED THE GOVERNMENT'S STATED OBJECTIVE OF UNIFYING EXCHANGE RATES AND LIBERALIZING CONTROLS ON FINANCIAL OPERATIONS. THUS IT IS WIDELY BELIEVED THAT TODAY'S ACTION MAY BE THE FOREFUNNER OF OTHERS WHICH COULD EVENTUALLY UNIFY THE EXCHANGE MARKET.

3. IN A SEPARATE ANNOUNCEMENT, THE GOU TOOK ANOTHER STEP IN ITS MINI-DEVALUATION POLICY FOR THE COMMERCIAL RATE. THIS WAS DEVALUED BY 3.6 PERCENT TO A SELLING RATE OF UP\$1300 PER DOLLAR, THE NINTH SUCH DEVALUATION SO FAR THIS YEAR.

4. COMMENT:

A) THE FINANCIAL RATE LAST WEEK WAS ABOUT UP\$1640 AND THE ILLEGAL PARALLEL RATE UP\$2100. IT IS EXPECTED THAT THE FINANCIAL RATE WILL RISE QUICKLY (COMPLETELY DISPLACING THE BLACK MARKET) AND THERE IS CONCERN THAT SPECULATIVE PRESSURES MAY DEVELOP IF THE RATE CHANGES TOO RAPIDLY. GIVEN THE UNATTRACTIVE INTEREST PAID ON PESO DEPOSITS HERE IN RELATION TO THE INFLATIONARY

EXPECTATIONS, IT IS VERY POSSIBLE THAT THERE WILL BE EXTENSIVE SHIFTING INTO FX. IF THE CB ATTEMPTS TO CONTROL A NEW RATE, THIS COULD BE COSTLY IN TERMS OF RESERVES. MOREOVER, A WIDENING GAP BETWEEN THE FINANCIAL AND COMMERCIAL RATES WILL PUT INCREASING PRESSURE ON THE GOVERNMENT TO ACCELERATE ITS MINI-DEVALUATIONS OR ABOLISH THE SEPARATE COMMERCIAL RATE ALTOGETHER.

B) THE INITIAL REACTION FROM THE BANKING AND COMMERCIAL SECTORS TO THE GOVERNMENT'S ANNOUNCEMENT HAS BEEN POSITIVE, ALTHOUGH THE TEMPORARY CLOSURE OF THE FX MARKET PREVENTS ANY ASSESEMENT OF TRENDS AS YET.

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C) THE NEW DECREE IS A BOLD MOVE TO CARRY OUT VEGH VILLEGAS' PROMISE OF "AUDACIOUS" ACTIONS TO COUNTER URUGUAY'S ECONOMIC STAGNATION AND BOP CRISIS. THIS IS THE FIRST TIME IN MANY YEARS THAT URUGUAYANS WILL BE ABLE TO FREELY CONVERT PESOS INTO HARD CURRENCY FOR NON-TRADE TRANSACTIONS. THE DIFFICULT MANAGEMENT OF THE TRANSITION NOW STARTED TOWARD AN EQUILIBRIUM RATE WILL TEST THE TECHNICAL SKILLS AND POLITICAL SUPPORT OF THE NEW ECONOMIC TEAM HERE. IT MAY WELL REQUIRE THE USE OF THE

GOU'S GOLD RESERVES TO SMOOTH THE WAY BEFORE A NEW EQUILIBRIUM RATE IS ESTABLISHED. SINCE TRADE TRANSACTIONS ARE NOT INVOLVED, WE DO NOT EXPECT THE CURRENT MOVE WILL AFFECT LOCAL PRICES. THUS, IT SHOULD ONLY HAVE A LIMITED IMPACT ON THE POSITION OF ORDINARY URUGUAYANS.

D) THE ANNOUNCEMENT CAME AS A SURPRISE TO THE BANKING SYSTEM ALTHOUGH THE GOU'S ECONOMIC TEAM HAD BEEN ACTIVELY DISCUSSING ALTERNATIVE MONETARY REFORM STRATEGIES. WE MUST ASSUME THAT SUCH A BASIC AND EVEN BOLD ECONOMIC MEASURE (PARTICULARLY ONE IMPLYING THE POSSIBLE USE OF GOLD RESERVES) WOULD NOT HAVE BEEN TAKEN WITHOUT CONSULTATION WITH KEY MILITARY FIGURES. IF THIS PROVES NOT TO BE THE CASE (AND WE DO HAVE ONE REPORT THAT AT LEAST SOME KEY MILITARY WERE NOT CONSULTED), THEN PRESIDENT BORDABERRY AND MINISTER VEGH MAY HAVE A DIFFICULT POLITICAL PROBLEM.
SIRACUSA

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